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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of the Cable Television Consumer Protection and Competition Act of 1992	)	MM Docket 93-215
Rate Regulation	)	

COMMENTS OF THE COMMUNITY ANTENNA TELEVISION ASSOCIATION, INC.

Community Antenna Television
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August 25, 1993

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SUMMARY

The Community Antenna Television Association ("CATA") urges the Commission to adopt cost-of-service regulations and alternatives that are accessible to the vast majority of cable television systems. CATA believes that any cost-of-service regulations should be designed to result in a fair rate of return for cable systems and not merely to reinforce the regulatory results of the Commission's price benchmark process.

Based on an analysis of the Commission's proposals in this Docket by Peter Pitsch of Pitsch Communications, CATA has concluded that the Commission's initial findings with respect to cable industry cost of debt, cost of equity, and the resulting rate of return are too low. The Commission erred in comparing cable companies to less volatile industries, such as public utilities, and ignored the fact that accepted measures of risk indicate significant differences between the Commission's chosen surrogate for risk analysis, the S & P 400 and cable television companies. CATA recommends that the <u>minimum</u> rate of return permitted the cable industry should be 14.5%, and realistically, because most companies do not have access to public debt and equity markets, and because, moreover, the Cable Act of 1992 and attendant regulations have greatly increased investor risk in the cable industry, the rate of return should probably be anywhere from 17% to 20%.

CATA argues, moreover, that the proposed selection of original cost to value cable systems is too restrictive and does not provide

the industry with proper incentives for new development. Rather, the Commission should value cable systems at market value. Similarly, the Commission's tentative decision to prohibit excess acquisition costs from inclusion in the ratebase is too restrictive. It is highly probable that these costs have been incurred in expectation of deferred future earnings in a growing industry, <u>not</u> in anticipation of monopoly profits. In any event, there is <u>no</u> justification for prohibiting the inclusion of excess acquisition costs in the ratebase if such costs were incurred during a period of rate regulation - either before 1984, or after 1992. CATA also contends that cable systems should be allowed to place in the ratebase costs associated with system re-builds before resulting cable plant has become "used and useful" as proposed by the Commission. This will be necessary if systems are to be able to obtain financing for future growth.

Based on the Pitsch analysis, CATA recommends that as one alternative to its regulatory process the Commission adopt a series of "competitive penetration benchmarks." Under such a system, the Commission would have a method of measuring consumer acceptance cable services. Systems whose rates exceed the Commission's price benchmark would have the opportunity to offer new or better services. An appropriate level of increased subscriber penetration would indicate acceptance of the increased quality of service and well as the rate. Under an easily administered system of competitive penetration benchmarks, rates would reflect competitive performance even in the absence of "effective competition." CATA maintains that a penetration benchmark scheme, while applicable to all cable systems, could be made available as an alternative to price benchmark or cost-of-service regulations for smaller cable systems almost immediately.

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COMMENTS OF THE COMMUNITY ANTENNA TELEVISION ASSOCIATION, INC.

1. The Community Antenna Television Association, Inc., ("CATA"), hereby files comments in the above-captioned proceeding. CATA is a trade association representing owners and operators of cable television systems serving approximately 80 percent of the nation's more than 60 million cable television subscribers. CATA files these comments on behalf of its members who will be directly affected by the Commission's action.

INTRODUCTION

2. CATA believes that any cost-of-service regulations adopted by the Commission be accessible to all cable systems. The regulations must be as simple as possible, be relatively easy to administer, and must be drawn to provide a real alternative to

the benchmark process. To this end, CATA has had the Commission's cost-of-service proposals analyzed by Peter Pitsch of Pitsch Communications (See Appendix). In particular, Mr. Pitsch has examined alternatives for a streamlined approach to cost-of-service regulations, the process by which the Commission has proposed a permissible rate of return, the proper method to evaluate a cable system's rate base, and the Commission's approach to the subject of depreciation.

3. CATA has concluded that the Commission proposals are flawed in several respects. It has underestimated both the cost of debt and the cost of equity for the cable industry and, as a result, underestimated a reasonable rate of return. Further, the Commission's proposal to prohibit the inclusion of excess acquisition costs in the rate base ignores the possibility, if not the likelihood, that these costs were incurred not in anticipation of monopoly rents, but in anticipation of deferred future earnings in a growing industry. In order to alleviate questions about excess acquisition costs, reduce speculation in cable systems and encourage system innovation and growth, CATA recommends that cable systems be valued at their market value. Moreover, CATA urges the Commission to recognize that the panoply of regulations mandated by the Cable Act of 1992, has itself greatly increased investor uncertainty and risk. Unless this factor (ignored by any standard method of risk evaluation) is taken into consideration, any determined rate of return will be

artificially low, especially for the majority of systems without access to public debt and equity markets. Finally, CATA urges the Commission not to prescribe depreciation schedules, but rather to allow companies to choose a depreciation policy best suited to their needs.

4. The Congress has placed the Commission in a most difficult position. The Cable Act of 1992, that clearly intended to lower cable rates - at least for some systems - also requires the Commission to pay heed to foster cable development. The same Act that requires the Commission to adopt regulatory policies designed to check what was perceived as run-away rate increases also requires that due attention be paid to assuring that cable systems are profitable. Having satisfied its own need to regulate, the Congress has given the Commission a seemingly contradictory set of instructions. This has been followed by veiled and not so veiled threats to the Commission's budget should what some legislators perceive as the appropriate pound of flesh not be paid.

5. The Commission has pending before it more than a score of Petitions for Reconsideration of its Report and Order establishing a benchmark system of rate regulation. It has been demonstrated that the basis upon which the benchmarks were constructed was faulty, that the Commission did not pay due consideration to the various factors that Congress instructed it

to consider, that the benchmarks themselves are unfair, and that the process for determining benchmark rates is complicated and burdensome, even for larger cable systems. The Commission itself has stayed the application of the regulations for cable systems with under 1000 subscribers. It is clear that significant adjustments will have to be made. Indeed, we note that in the instant Notice the Commission has given its Mass Media bureau authority to gather the information that should have been used in the initial construction of the benchmarks.

6. Given the churn and uncertainty associated with the Commission's attempts to establish a reasonable benchmark system, cable systems must have a genuine opportunity to demonstrate that their costs justify their rates. Indeed, given the very real possibility that some or all of the benchmark process will not survive the inevitable court challenges, it is all the more important that the Commission have some system in place that will fairly and simply permit rate regulation for the cable industry. If the Commission adopts a cost-of-service package accessible only to a few, then its entire regulatory scheme will be viewed only as a process to lower rates regardless of the exigencies faced by cable systems, regardless of their need to re-build their plants, regardless of their right to a reasonable profit, and, ultimately, regardless of the public interest.

7. The Commission has chosen, and, in fact CATA and others have generally supported, a benchmark rather than a cost-of-service approach to rate regulation because, at least in theory, a benchmark approach is simpler for both the regulators and the regulated. That is not to say, however, that cost-of-service rules cannot work. If properly constructed, cost-of-service regulation should take system costs into account, assure a reasonable profit, and result in reasonable rates for subscribers. If, however, at each decisional point, the Commission keeps a weather eye on the Congress, and errs against cable systems' ability to recover their costs, then what the Commission characterizes as a "backstop" for the benchmark process will become merely another set of empty regulations.

8. The Commission claims that one of its goals is to "encourage economically justified expansion of the cable infrastructure." But this goal cannot be attained without the detailed knowledge of cable system costs that the Commission admits it lacks. Nevertheless, the Commission has proceeded not merely to obtain the needed information, but to make specific proposals. The Commission has demonstrated that wherever a choice is likely to result in lower rates, it will take that approach, even though it claims that it must strike a "balance" between the interests of consumers and the desire to encourage expansion of cable infrastructure and even though it still lacks the necessary cost information to achieve the balance. Thus it

has proposed that the cable plant be valued at original cost, rather than market value or replacement cost even though it admits that choosing replacement cost would encourage re-building and innovation. It has proposed to disallow excess acquisition costs (indeed, all intangible costs). The record does not demonstrate, however, that these costs are of no value to subscribers. It has proposed the "used and useful" test for plant under construction, ignoring the necessity of most systems to obtain the capital to construct in the first place. In short, just as when it constructed its benchmark process, the Commission has obtained little information about the cable industry, but has nevertheless proposed a regulatory scheme. The Commission must take great care that it does not pursue a Notice of Proposed Rulemaking whose primary goal is preserving the benchmark regulations and little more.

STREAMLINED ALTERNATIVES

9. In recognition of the complexity of cost-of-service regulation, the Commission has wisely suggested several alternatives. It has suggested that rates be considered reasonable if they are no higher than 1986 rates adjusted forward both by an inflation factor and by a "productivity offset." Depending on the numbers chosen, it is difficult to comment on this proposal. Its attraction is that it recognizes that some rate increases have been entirely justified. Increases based on

inflation, of course, should only be a starting point. Rate increases associated with system upgrades, for instance, should also be permitted. The Commission has also suggested requiring operators to present costs in only one or a few key areas, or that if excess acquisition costs account for competitive and non-competitive differentials, then to allow cost showings that exclude such costs. It has suggested permitting systems to justify costs based on the average costs of all or similar systems. The key here will be which factors the Commission might use to define similarity. If it continues, for instance, to ignore subscriber density, then there will be built-in inequities in such a system. It has suggested permitting operators to justify costs for planned upgrades so that rate increases based on these costs can be added to the benchmark rate. Of course, if the Commission permits systems to make a streamlined showing to justify benchmark rates for <u>planned</u> upgrades, it should recognize that systems have been upgrading all the time and therefore it should allow similar showings to justify higher than benchmark rates based on <u>past</u> upgrades.

10. CATA believes that all of these alternatives may have merit and should be explored. Most important, the Commission should not choose just one "streamlined" approach. Systems should be permitted to choose between these alternatives depending on which approach appears simplest and may fit individual circumstances best. It does seem, however, that even

these simpler alternatives can still be complex and time consuming. Based on the Pitsch analysis of the Commission's proposals and its benchmark system, CATA suggests another, even simpler approach that may prove attractive for many systems.

11. Competitive Penetration Benchmarks. The Commission's benchmark system sets cable rates while attempting (and failing) to create incentives for cable systems to provide subscribers with more services. The Commission's goal is to have rates reflect competitive performance. It has already determined a relationship between cable rates and effective competition as defined by the Cable Act. But clearly, price is not the only measure of value important to subscribers. Pitsch shows that the Commission can develop a relationship between price and other factors affecting the demand for cable service and subscriber penetration levels. Using the Commission's database and employing multiple regression analysis Pitsch illustrates how a penetration benchmark might work. For example, under his results if cable prices are reduced by 10% (the presumed result of effective competition) subscribership would increase by roughly 2%. By developing such a competitive penetration benchmark, the Commission could permit systems an alternative to price benchmarks.

12. Nothing in the Cable Act prevents the Commission from adopting a penetration benchmark system as a regulatory

alternative. Congress was concerned that cable service be provided on competitive terms. Competitive performance is not one dimensional. Besides prices close to cost, competitive firms provide new services and quality improvements. Such overall performance is rewarded by consumer acceptance in the marketplace. A penetration benchmark system provides just such a measure of consumer acceptance. If a given cable rate is above the Commission's price benchmark, but the system's penetration level is above the penetration benchmark, then it is reasonable to assume that increased service quality justifies the rate. Under penetration benchmarks, cable systems would have the incentive to provide competitive value which might well include quality improvements that justify prices above the Commission's price benchmarks.

13. The alternative of a competitive penetration benchmark system has various advantages. As discussed, it creates the type of incentives to upgrade cable system performance that price benchmarks lack. Penetration benchmarks would also provide a better measure of good performance, and permit cable operators the flexibility to improve service as they deem most appropriate to their circumstances. Unlike cost-of-service regulation, a penetration benchmark system would be insensitive to questions of cost subsidy and cost allocation because it provides a direct measure of consumer satisfaction. Further, unlike the price benchmark system and cost-of-service regulations, a penetration

benchmark system would be administratively simple and least burdensome to the industry and local regulators.

14. Given the work necessary to develop a competitive penetration benchmark system, CATA recognizes that the Commission might wish to restrict its use at first to the smaller cable systems for whom the price benchmark system and any cost-of-service regulation is most burdensome. In theory, however, a competitive penetration benchmark system could apply to systems of all sizes, and CATA encourages the Commission to pursue such a goal. We further recognize that some systems will not benefit from this proposal. Some very small, older systems are heavily penetrated and perhaps not likely to be able to raise subscriber levels. Thus we regard a competitive penetration benchmark systems as one other alternative, although potentially a highly useful one.

RATE OF RETURN

15. Debt/Equity Ratio. Based on the Pitsch analysis, it is apparent that there is a wide variation of debt/equity ratios throughout the cable industry. Pitsch concludes, based on analysis of the few companies with publicly available debt/equity information, that "...while it is problematic to pick one industry-wide number in an industry that is undoubtedly characterized by more variation than is customary in utility

industries, the FCC's proposed 50/50 debt/equity ratio is the appropriate one." He warns, however, that because many companies may not be able to borrow in today's lending environment, individual companies should be free to demonstrate that their capital structure justifies basing cost of capital on a lower debt/equity ratio. Thus, while practical considerations may require developing a presumptive debt/equity ratio, the Commission should adopt a liberal waiver approach that permits individual cable systems to demonstrate that a different debt/equity ratio is appropriate to their circumstances.

16. Cost of Debt. The Commission's choice of a cost of debt of 7.5% is demonstrably too low. It's determination was based on bond yields for public utilities, but clearly cable systems have considerably higher debt costs. As explained in detail in the Appendix, Pitsch examined market yields on bonds and the bond ratings of cable companies with public debt. Debt costs were found to range from 8.84% to 10.59%. These estimates, of course, are extremely conservative. Most cable systems do not have public debt and surely have substantially higher debt costs. These systems do not have access to public bond markets and must either sell parts of their companies or obtain loans from banks. Under these circumstances, Pitsch concludes, a cost of debt of 11% would be a more appropriate industry-wide estimate, and even this figure is conservative.

17. <u>Cost of Equity</u>. As it did with cost of debt, the Commission has understated equity cost for the cable industry. In choosing the S & P 400 as a surrogate for a risk analysis, the Commission seems to have ignored the fact (as demonstrated in the Pitsch analysis) that accepted measures of risk evidence significant differences between S & P 400 companies and cable television companies. Analyzing beta coefficients (measures of volatility of stock compared to the stock market as a whole) of publicly traded firms, Pitsch shows that the risk factor of cable firms is as much as 50% higher than S & P 400 firms, and even higher when compared to telephone companies.

18. Using several different approaches to determining an appropriate cost of equity figure for the cable industry, Pitsch concludes that while the Commission has proposed a range of between 12% and 17%, a <u>conservative</u> estimate yields a figure of at least 18%. Again, it must be emphasized that this analysis was performed based on published data for the few large publicly traded cable companies. Most cable companies are considerably smaller, and, from an investment standpoint, riskier enterprises. They are unable to raise capital in the public debt or stock markets and so both their debt and equity costs will be much higher.

19. <u>Cost of Capital - Rate of Return</u>. Applying the more appropriate numbers for debt and equity costs, and assuming a

50\50 debt\equity ratio, the Pitsch analysis demonstrates that whereas the Commission recommends a rate of return ranging from 10% to 14%, the figure should be <u>at least</u> 14.5% Given the fact that most systems do not have access to public debt or stock markets, it is reasonable to conclude that an industry-wide rate of return should probably lie in the 15% to 17% range. But a consideration of rate of return for the cable industry cannot stop with traditional methods of economic analysis.

20. It must be realized that if developing an appropriate rate of return is dependent on an analysis of investor risk, the Congress, and to some extent the Commission, have injected considerable uncertainty into the process. It is one thing to stand apart from the fray and measure risk by whatever sophisticated technique seems best. It is far from clear that these techniques adequately reflect the new risks created by the 1992 Cable Act and attendant FCC regulation. For instance, it is not possible to choose a surrogate, be it the S & P 400 or any other, that is facing a government mandated rate reduction of at least 10%, with an ill-defined specter of possibly more in the future. The new cable regulatory scheme has increased investor risk dramatically in many other ways as well.

1. It is not at all clear that many cable companies will be able to continue to service their present debt.

2. It is not at all clear that the costs of necessary system upgrades will be recoverable.

3. Systems are being made to carry television stations of little economic value and are being forced to cease

carriage of stations of greater value. It is certainly unclear how offering less valued product will affect system revenues.

4. Systems must now negotiate retransmission consent rights, a process fraught with uncertainty.

5. Systems face the prospect of re-tiering and providing additional equipment in order to comply with anti-buythrough and, eventually, equipment compatibility regulations.

6. Systems face additional expenses in order to comply with customer service regulations.

This list could go on and on. What kind of judgment is a prospective investor to make? It appears as if government has created a new "uncertainty principle." By its own actions it is dramatically increasing the level of investor risk while trying at the same time to measure the risk as if cable were in a largely static environment. Even if we pretend that massive investor uncertainty does not exist, we have shown that the Commission's proposed rate of return is too low. If we stop for a reality check and acknowledge the increased risk of government's own making, we are compelled to conclude that an appropriate rate of return is likely to be as much as 20%.

21. Valuation of Plant in Service. The Commission has proposed to use original cost as a means of valuing plant in service. While recognizing that using the original cost methodology does not provide an incentive for systems to upgrade, the Commission notes that it will result in lower rates for subscribers. CATA believes that the Commission should allow operators to value plant in service at its current market value.

To do so will ultimately result in systems that produce the greatest value for their subscribers. Moreover, valuing a system at current market value rewards management efficiencies, permits the recovery of upgrade costs, and promotes the efficient acquisition and transfer of cable systems because the present market value of a system is constant.

22. Plant Under Construction. The Commission has requested comment on whether it should apply the traditional rule under ratebase/rate-of-return regulation that plant under construction be withheld from the ratebase until it meets the "used and useful" test. CATA urges the Commission not to take this approach. The cable industry, unlike most rate-of-return regulated industries, is characterized by growth and re-building to accommodate technological change and to provide new services. Cable, unlike gas companies or electric companies, is not a one product industry. Traditionally, it has made significant changes in its technical capabilities on the average of once every six or seven years (See comments of Tele-Communications, Inc., ET Docket No. 93-7, March 22, 1993). There is a need, therefore, for most systems that do not sell stock to obtain loans to finance re-building. These capital costs must be included in a ratebase before the new construction is complete - "used and useful." In many cases it will be impossible to obtain financing unless the cable operator is able to show an ability to begin immediately repaying principal and interest from system revenues. In the

past, many systems faced with new construction or re-building costs had to raise subscriber rates. In a regulated environment, this will still be the case and the Commission must adopt cost-of-service policies to facilitate the practice.

23. Excess Acquisition Costs. Current market valuation of cable systems solves the problem of excess acquisition costs. To the extent that acquisition costs are within a system's current market value they should be recoverable. If the Commission determines not to permit current market valuation of cable systems, it must consider regulations for excess acquisition costs. Its proposal, to disallow them, is much too broad. First, it must be noted that any acquisitions that occurred before the 1984 Cable Act or after the 1992 Cable Act occurred or will occur in either a regulated or a competitive environment. Under these circumstances, there should be little concern that excess acquisition costs reflect expectation of monopoly profits. Second, for acquisitions between 1984 and 1992, systems should have the opportunity to show that any excess acquisition costs were not in expectation of monopoly profits. As the Commission, itself, has pointed out, other factors may explain excess acquisition costs. Indeed the most obvious explanation for excess acquisition costs is that they reflect an expectation of future earnings in a rapidly developing industry. Cable has been and (hopefully) still is expected to grow and offer new services. Indeed with government and the press as cheerleaders, the public

is being told that cable will have a significant role in a new telecommunications infrastructure. Cable is in a position (with increased investor risk, it should be noted) to contribute to a communications revolution. Might not some entrepreneur excited at the prospect of being part of this revolution pay excess acquisition costs as an investment in future earnings? Of course. This type of investment has been going on for years and the Commission should not adopt cost-of-service regulations to discourage it. Moreover, CATA shares the concern of Commissioner Duggan and others that perfectly legal past conduct not be penalized now.

24. Depreciation Rates. CATA believes that any prescription of depreciation rates at this time would be a mistake. Each cable system should be permitted to choose a depreciation rate most appropriate to its needs. Obviously, there are trade-offs between choosing a rapid as opposed to a slower depreciation rate. It is certainly not clear that all systems will make the same choices. Certainly, at the present time the Commission has little basis for prescribing a rate that would be appropriate for all systems.

25. Small Systems. The Commission has requested comment on whether it might modify any of its cost-of-service proposals to reduce the burdens placed on cable systems with 1000 or fewer subscribers. CATA continues to believe that the Cable Act does

not prevent the Commission from exempting such systems wholly from its rate regulations and urges the Commission to grant an exemption. Indeed, the Commission's recent stay of its regulations for small systems indicates that such relief may be under consideration. Short of a total exemption, CATA believes that serious consideration should be given to the proposal of the Small Systems Coalition that rates be deemed reasonable based on a measure of net income. Clearly, any system of regulation that might contemplate full-blown cost-of-service showings for small cable systems would be unfair.

CONCLUSION

26. CATA believes that the Commission must construct cost-of-service policies and alternatives that can stand alone as substitutes for the benchmark process. To this end, it is necessary for the Commission to offer regulatory policies that are accessible to all regulated cable systems, not just those with teams of accountants. Smaller systems should be excluded from rate regulation altogether. In order to speed the administrative process and relieve regulatory burdens, the Commission should permit a full range of streamlined alternatives for regulated systems. As one alternative, CATA recommends the Commission consider the establishment of competitive penetration benchmarks that would allow systems to "opt out" of the benchmark

process by showing that their rates are justified by increased consumer satisfaction as measured by penetration increases.

27. Cable operators seeking to make cost-of-service showings should be permitted to value their systems at market value, thus largely eliminating the necessity for debate over the historical motives behind payment of excess acquisition costs. In any event, the Commission must realize that these costs, to a large extent, reflect investor confidence in industry growth, <u>not</u> an expectation of monopoly profits. CATA further urges the Commission to revise its estimates of debt and equity costs and a permissible rate of return. The Commission's figures do not adequately assess the risk factors facing cable investors, but rather seem based on companies that have historically had considerably less investment risk, and which certainly have not been exposed to the heavy burden of regulation required by the Cable Act of 1992.

Respectfully submitted,

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APPENDIX